Report on Investments

Fourth Quarter, 2020

Economic Review

4Q20. After its January 27th meeting, the Federal Reserve Open Market Committee (FOMC) stated, "The pace of recovery in economic activity and employment has moderated in recent months…" A more negative tone than their September and November statements where they stated economic activity and employment had "picked up" and "continued to improve". Different week, different story seemed to be the economic news pattern in the 4th quarter.

The ebbs and flows of the pandemic continue to drive economic expectations and economic forecasting has been difficult at best. There were plenty of economic events to digest in the fourth quarter - a presidential election, which was quickly overshadowed by Pfizer's vaccine announcement November 9th, followed by a spike in COVID cases and lockdowns in a number of states, followed by a Moderna vaccine announcement, followed by Congress trying to come together on a stimulus package, and don't forget possible changes to fiscal and monetary policy, etc.. But most important was progress with COVID.

Even with the promise of vaccines in the news, another spike in COVID cases and hospitalizations in November and December made consumers more cautious, resulting in a drop in retail sales and more layoffs. Retail sales and incomes fell in November and spending contracted for the first time since April. In December, jobless claims increased to a three-month high. Despite this the markets kept focused on hopes for a recovery.

<u>GDP</u>
Fourth quarter GDP rose 4.0%. The increase reflected both continued economic recovery from the sharp declines earlier in the year and the ongoing impact of the COVID-19 pandemic, including new restrictions and closures that took effect in some areas of the United States. GDP saw big swings during 2020, largely driven by changes in consumption, going from -30% in the second quarter, to up 32% in the third quarter, then settling down to 4.0% in the fourth quarter. Annual growth for 2020 is expected to be -3.5% from 2019. Long-term trend is +2% annually.

<u>Employment</u>
The labor markets had been improving steadily since April until they took a turn for the worse in the fourth quarter. December was the first monthly job loss since April. Half a million people lost their jobs in leisure and hospitality (restaurants and bars) due to new lockdowns. Although the unemployment rate has dropped from a high of 14% in April to 6.7%, nationally there was a net job loss of $9 million jobs in 2020. Even though unemployment may continue to fall in 2021, labor markets will take a few years to reach pre-crisis levels.

<u>Inflation</u>
Inflation expectations did increase slightly during the 4th quarter due to the prospect of more fiscal stimulus, vaccines and the economy reopening. The loss of income for millions of households should depress demand and spending and reduce inflationary pressures in 2021. In a world of high unemployment, businesses will have little pricing power. Fourth quarter inflation was 1.4%, below the Federal Reserve target of 2.0%.

Interest Rates

Since the beginning of the year short-term rates dropped from above 1.5% to 0%. Yields on the 10-year Treasury Note went from 1.92% to a low of .50%. During the 4th quarter the Fed continued to keep short-term interest rates pegged at zero to stimulate and provide liquidity to the COVID economy. Expectations are the Fed will keep rates near zero into 2022 or longer. Yields on bonds two years and shorter did not change to any degree in the fourth quarter. There was a steepening of the U.S. Treasury yield curve 3 years and longer. The primary reason for the bounce in longer-term rates was the expectation of improvement in economic performance with a reopening in 2021. With vaccine rollout leading to a strong recovery, more people going back to work, increasing incomes, and pent up demand and spending leading to a bump in inflation. Most economists do not expect any meaningful or lasting uptick in inflation in 2021.

Equity Markets

Despite uncertainty and volatility, the equity markets kept pushing higher during the quarter. The financial markets seemed to focus on the extremely accommodating Fed, optimism over more US stimulus, the arrival of vaccines and hopes for a strong recovery. The equity market's push higher seemed to be faster than the pace of actual economic growth, leading some financial market experts to think equity prices had become over valued and predict a market correction in 2021. Nonetheless stocks recorded a more than solid gain in the quarter. The S&P 500 finished up 11.7% for the 4th quarter and 16.3% for 2020.

Present. Unfortunately, there were spikes in COVID cases during the fourth quarter which resulted in new lockdowns and jobs losses. There are still millions of people out of work and many small businesses continue to struggle. More stimulus seems to be coming to help those in need. Despite these issues, the market continues to be focused on vaccines and recovery prospects. The Fed is very accommodative, keeping short-term rates near zero. Long-term rates have bumped higher on economic expectations but are still very low. Corporate earnings have mostly beaten expectations and the housing market is very strong with low interest rates. The economy is recovering and the equity market seems to still be in a bull market.

Future. The progress of the vaccine rollout and the strength of recovery will dictate the markets in 2021. With an accommodative Fed, low interest rates and low inflation the economy has a base for solid growth. Although some believe the equity markets have gotten ahead of the economy and may experience a correction in 2021. The Fed is on hold and is expected to keep short-term rates very low for at least the next 12 months. The story to watch is how the vaccine and stimulus stories unfold in 2021.

Council Impact. The Council's short-term portfolio is directly impacted by Fed policy and it is expected the Fed will maintain short-term rates at very low levels for at least the next 12 months. Low rates interest rates will continue to reduce portfolio earnings. An economic recovery in 2021 could result in an uptick in inflation and more steepening of the yield curve. The Council's long-term portfolio has and will continue to selectively take advantage bumps in intermediate yields to increase portfolio earnings. Even though the Council is generally a buy and hold investor, the long-term portfolio could experience price depreciation on its holdings if medium-term interest rates do increase. To minimize price loss, we intend to maintain duration slightly shorter than the benchmark. The strong performance of the equity markets has greatly benefitted the OPEB Trust.

Investment Results & Strategy

MCOA—Short-Term

4Q20 Results*:* The Short-term portfolio generally matched the performance of its benchmark during the fourth quarter. Total return was 0.011% versus the Crane Government Money Fund index total return of 0.005%. This really demonstrates how low very short-term interest rates are. The portfolio has outperformed its benchmark by an average of 13 bps annually over the past 10 years. At the end of the fourth quarter, the portfolio was invested in government money market funds (43.7%), U.S. Government Agency Discount Notes (27.2%) and U.S. Treasury Bills (29.1%). Earnings in this portfolio continue to be hurt by the extremely low short-term interest rates. The average yield of the portfolio remained at .05%, same as the third quarter. A stark difference from the 1.65% average yield at the end of 2019.

1Q21 Strategy: This portfolio will continue to be managed using a short duration laddered strategy, providing liquidity and timing investment maturities to large cash flow needs such as payroll, capital expenditures and debt service payments. Investments will be made in allowable short-term liquid securities such as Treasury Bills, Government Agency Discount Notes, government class money market funds, and possibly the highest rated Commercial Paper. Purchases will be diversified amongst security types with maturities less than on year. Short-term interest rates are expected to remain near zero for all of 2021. At their 1/27/2021 meeting, the Fed stated they expect to maintain their very accommodative monetary policy until the labor market has reached maximum employment and inflation exceeds 2% for some time. The Fed's target rate is 0-.25%. Most economists do not expect the economy to reach the Fed's employment and inflation goals in 2021 given the current unemployment level, low inflation and uncertainty around economic recovery from COVID-19.

Longer Strategy (12+months): The portfolio will continue to be managed to meet cash flow needs and invested in high quality statute eligible securities with maturities less than 1 year. We will continue to monitor the short-term interest rate environment and expectations. The portfolio will maintain diversification amongst investment types while looking to maximize earnings. Available securities offering the highest yields will be compared. Securities purchased will comply state statute and Council investment policies. Securities purchased will likely include U.S. Treasury Bills, Government Agency Discount Notes, Commercial Paper, and government class money market funds. We expect interest rates to remain at very low levels into 2022.

MCOA—Long-Term

4Q20 Results*:* The Long-term portfolio outperformed its benchmark for the fourth quarter. Portfolio total return was .36% versus the BAML Agency Master index return of .037%. The portfolio had a defensive position against rising interest rates with a duration (1.53 years) shorter than its benchmark (3.89 years), this benefited the portfolio return as intermediate yields increased and the curve steepened. At the end of the quarter, the portfolio was invested in U.S. Government Agency securities (79%), government money market funds (10%), municipal bonds (6%), Certificate of Deposits with local community banks (3.0%), U.S. Treasury Notes (2.0%) and less than 1% in securitized mortgage backed securities.

1Q21 Strategy: For the past 12 months this portfolio has maintained a defensive stance with a duration short of the benchmark. This made sense as we began 2020 with a very flat yield curve, economic and budget uncertainty around COVID-19, and low interest rates. Yields continue to be at low levels in the short and intermediate parts of the curve where the Council invests, and we expect them to stay low. But we have seen some steepening in the 3-7 year part of the curve. This creates an opportunity to pick up yield in the portfolio by investing to that part of the curve. It may not be a time to meaningfully extend duration or take credit risk, but it is also not advantageous to be too short. We continue to add select high quality General Obligation taxable municipal bonds, U.S. Government Agencies, and some Treasuries. In support of our community, we also have some capacity to add Certificates of Deposits with qualifying community banks and credit unions that have a successful track record of supporting minority, female and other small businesses, affordable housing, community development, and equity.

Longer Strategy (12+months): Over the course of 2021 we will continue to watch the progress of the expected post COVID-19 economic recovery and the market expectations for changes to interest rates. We will look to take advantage of any yield curve steepening and/or a rise in interest rates to help increase the earnings of the portfolio. We will also look to maintain a full allocation to our CD program with qualifying community banks.

EFPMs – Hedging Accounts

4Q20 Results*:* Due to the drop of fuel prices, diesel futures contracts have generated realized losses at quarter end of ($1,259,811) and an unrealized gain of $3,063,257. This continues the wild swings in unrealized gains and losses throughout 2020 as the markets tried to navigate the pandemic. The current value of the diesel futures contract is $18.2 million as of December 31, 2020.

OPEB

4Q20 Results: The OPEB Trust outperformed its index during the 4th Quarter. The OPEB Trust returned 9.24% for the quarter versus a return of 7.18% for the Trust's blended index. The value of the OPEB Trust increased from $288.7 million to $315.8 million, an increase in value of $27.1 million. Currently, the Council's OPEB portfolio is invested with the State Board of Investment. The allocation is 78% in an S&P 500 equity index pool, 18% in U. S. Treasury securities, and 4% in a money market pool.

1Q21 Strategy: The OPEB Trust portfolio is a long-term investment, which will experience positive and negative market movements over time. We experienced this in 2020 with the historic volatility in the equity markets caused by the economic effects of the COVID-19 pandemic. Over the long term, staying the course in tough markets is a good strategy. The Council's future OPEB liabilities are in a strong funding position. The Council has targeted an allocation of 60% equities and 40% fixed income/cash. Because of the strong performance of the equity markets, the current allocation of 78% equity and 22% fixed income/cash is not in alignment with the target allocation and may warrant adjusting.

Longer Strategy (12+months): We may move to an asset-liability management approach which will mean further reducing the investment risk of exposure to equities. This is in preparation for using trust assets to fund employee OPEB benefit distributions.